Long-term value creation

By Dirk Gerritsen

We had the pleasure to speak with Alex Edmans, Professor of Finance at the London Business School. We talked about ESG and its various shortcomings. Prof. Edmans makes the case to focus more on long-term value creation instead. We discussed various drivers of long-term value, and also to what extent these drivers have overlap with ESG. The conversation concludes with recommendations for CFA charter holders.

You are widely recognized for your research on long-term value creation, a process oftentimes referred to as ESG. Recently, ESG became under attack in the US. What is your take on the ESG polarization?

I find this polarization highly surprising. ESG is potentially powerful because it is a way of improving the long-term performance of a company. This should be of interest to everybody, both Democrats and Republicans. Republicans seem to be anti-ESG since companies should be about making money and earning returns. But ESG is a useful tool to help long-term performance. To me, the polarization is therefore rather confusing.

If that's the case, why then are some Republicans profoundly anti-ESG?

I think it's the rather evangelical way in which people have been presenting ESG. Some ESG advocates think that ESG is the most important thing about a company. For example, if a new director is appointed, their gender or ethnicity matters more than their experience, abilities, or cognitive diversity.

And this thinking of you culminated in your recent academic article The end of ESG, published in the journal Financial Management?

Yes, exactly. Of course ESG is important, but it is nothing special. It should not be put on a pedestal above other things which are essential to a company's performance. The backlash against ESG is a reaction to many people viewing it as so important that you get cancelled if you're not doing ESG, irrespective of how well you're performing on all other dimensions.

Could the polarization lead to valuation differences for firms that "do" ESG in the US compared to Europe?

Companies interact with society and need to be cognizant about social norms. Indeed in the US, where many people are skeptical about ESG, you had the backlash to Bud-Light and to Target for taking actions that conflicted with many customers' values. Companies need to be sensitive to their context. Had those actions happened in continental Europe, there might not have been the same backlash.

Alex Edmans is Professor of Finance at London Business School. He has a PhD from MIT and was previously a tenured professor at Wharton and an investment banker at Morgan Stanley. He serves on the board of directors of the American Finance Association and was, until recently, the managing editor of the Review of Finance. Prof. Edmans serves as non-executive director of the Investor Forum, on the World Economic Forum's Global Future Council on Responsible Investing, and on Royal London Asset Management's Responsible Investment Advisory Committee. He wrote Grow the pie: How great companies deliver both purpose and profit, which was heralded as a Financial Times Book of the Year 2020.

The response to the backlash of some people is to say these people are wrong and backward. It's to ridicule them. But these people still vote and buy. They simply have different opinions, and it's unfair to claim their opinions are invalid. They have a different view as to what a company's goals should be, and a different view on what the next President should be. This view should be respected. If you fail to do so, you face a huge destruction of value like Target and Anheuser-Busch suffered.

These so-called woke advertising campaigns antagonized many people and led to short-term losses. But should long-term investors look beyond this and applaud these companies' efforts?

No, unfortunately not, as these campaigns can lead to a permanent reduction in value. These offended customers might never get back to your brand. See Nestle with their breast milk substitute scandal decades ago. They were aggressively marketing the substitute which deterred mothers from breastfeeding. Although it happened decades ago, its legacy still exists today and makes people worried about Nestle. Or take Wells Fargo as another example. It will take them a long time to recover from the fake bank accounts scandal. More generally the financial industry is still recovering from the financial crisis 16 years ago with people don't fully trusting banks.

Let's move to Europe where we have SFDR. What is your perspective on this regulation?

Now, there are many regulations which create taxonomies on what is good and what is bad. I think this is hugely problematic. With SFDR you have Articles 6, 8, and 9 and they are seen as a ranking, where 9 is better than 8 which is better than 6. Whether you can claim to be 6, 8, and 9 depends on the companies you invest in, but only on their quantitative characteristics.

Let's take employee diversity. You can measure things such as how many women there are in the workforce and how many ethnic minorities there are, but there's so many other aspects of diversity than just demographics. You could be a white male who was the first in your family to go to university, or you might have an engineering background when everybody else has a finance background. Reducing complex issues to a few boxes to be ticked is highly problematic.

> ESG IS POTENTIALLY POWERFUL BECAUSE IT IS A WAY OF IMPROVING THE LONG-TERM PERFORMANCE OF A COMPANY. THIS SHOULD BE OF INTEREST TO EVERYBODY, BOTH DEMOCRATS AND REPUBLICANS

Right now people will give you praise if you improve the diversity of your workforce, because that counts as ESG, but they won't give you praise if you take your junior employees to meetings and allow them to give part of the client presentation. In fact, that probably worsens your ESG profile because of your junior employees' carbon footprint, even though taking them is great for their human capital development. I think the problem with ESG is that it silos activities: if something's an ESG activity then people will praise you for it, if it's not an ESG activity, they don't care about it, but they should care if it creates long-term value.

In a similar vein, take environmental aspects; it could be that you reduced your carbon footprint by producing less, but now you're importing things from overseas. You can easily improve your carbon footprint by these nefarious methods. In this light, a recent paper shows that one way in which companies can easily improve their environmental statistics is by selling their most polluting plants to other companies. But the companies buying those polluting plants pollute even more. So you're improving your own metrics, but society is doing even worse.

So in short, it is better for mankind that relatively transparent companies run these plants?

Indeed, as long as the plant is producing something which is socially beneficial. So if you're producing tobacco, I do think the best thing to do is to destroy that plant because I don't think tobacco is socially beneficial, but there are many things that society needs which do cause harm in producing. For example, ammonia is really important for fertilizers. We need fertilizers because we have a large population with lots of very hungry people in developing countries. The production of ammonia creates harm to the environment. The same might be said of concrete, whereas concrete is again used to build schools and hospitals in many countries and regions around the world. So if it's something which is socially beneficial, I think it is better to do this in the least environmentally damaging way than to sell it to somebody else who might not care as much.

> THE PROBLEM WITH ESG IS THAT IT SILOS ACTIVITIES: IF SOMETHING'S AN ESG ACTIVITY THEN PEOPLE WILL PRAISE YOU FOR IT, IF IT'S NOT AN ESG ACTIVITY, THEY DON'T CARE ABOUT IT, BUT THEY SHOULD CARE IF IT CREATES LONG-TERM VALUE

In all these instances, think about what is the right counterfactual. The correct counterfactual is what would happen if somebody else was to own the plants and how polluting would they be. If somebody else doesn't care, then I think it's better for you to own and operate it.

I understand that ESG has its problems. What, in your view, creates value on the long run?

That depends from company to company. I don't like these ESG reporting requirements where every company should report carbon emissions because they clearly don't matter for the tech industry as much as they do for transport. So what matters for value creation should be at the judgment of a company. As a tech firm you would like to have a culture of innovation where people are bold and are willing to challenge. This might be different for a mining company where you don't want people to take risks and where you want people to follow the rules. So even for a single dimension, what is good for one firm is not good for another firm. You can extend that thinking to other dimensions: Carbon emissions are relevant for mining firms but not for tech firms. Given these nuances, you can't give one-size-fits-all rules for what drives long-term value.

There are these books or Harvard Business School articles claiming the five things that you need to do to be successful. But I find that ridiculous because it depends on what you're doing as a company. Take sports as an example and compare gymnastics to sumo wrestling. Being slim increases the likelihood of success in gymnastics but not sumo wrestling.

ESG IS IMPORTANT, BUT IT IS NOTHING SPECIAL. IT SHOULD NOT BE PUT ON A PEDESTAL ABOVE OTHER THINGS WHICH ARE ESSENTIAL TO A COMPANY'S PERFORMANCE

You need to think about the key value drivers for an industry rather than whether an activity is falling under an ESG label. Industry-specific materiality maps can help here, and even within industries, companies establish their own materiality map, highlighting material things. So you can't have universal one-size-fits-all rules such as every firm need to be a leader in racial equality, which is what a lot of ESG advocates seem to be suggesting. The football industry has been successful despite having few Asian footballers at the top levels.

ESG rating agencies try to capture different ESG metrics in one rating. Research shows that these agencies do not agree. Some argue disagreement is a bad thing, others argue the opposite. What is your view?

My view is that disagreement is good and natural. Differences of opinion emerge when different people put different weights on criteria. Take environmental performance. Clearly you want to measure carbon footprint, but what about electromagnetic radiation? Some people think it's important; other don't. Even if we agree that an issue is important, we don't agree on how to measure it. How female friendly a company is, is that the number of women in the workforce, the number of women on the board, the gender pay gap, or related to maternity leave? We don't know how to measure it, and even if we agreed on it, how do we weight the different components of ESG? Take equity analysts where one brokerage will issue a buy rating and another a sell rating. No-one will claim that they're not good at their job but everyone thinks instead that they have legitimate reasons for disagreement. I think also ESG rating agencies can legitimately disagree.

The value drivers that you mention seem to be very subtle and hard to capture in numbers, is that correct?

For sure, the things that likely lead to the greatest alpha are the things that won't be quantitative, otherwise they would have been priced in. One of the most important drivers of a company's performance is the quality of the CEO. But this is very hard to measure. Therefore more qualitative measures of performance are important. That's the reason that I looked at the employee satisfaction survey for one of my papers, which is a list which is compiled after surveying employees on qualitative factors. I think these factors are going to be much more value relevant than quantitative stuff.

The emphasis on long-term value creation is also central in your recent book Grow The Pie. What is this pie and how can it grow?

The pie is the value a company can create and this pie is divided among investors in the form of profits and society in the form of fair taxes, fair wages, and fair prices. Some people don't like ESG because they have the pie-splitting mentality: If I give more to workers, I have less for shareholders. But what I'm trying to highlight is how the pie can grow. If you pay your workers more, you treat them better, and you give them mentorship and skills, then they become more productive, more motivated, and more likely to stay. As a result, the pie grows. There are many win-wins possible here.

It seems possible for every firm to grow their pie as every firm can, for example, treat their employees well. But at the same time we talked about destroying tobacco plants. How does the latter fit in growing the pie?

I would say that shutting down a tobacco plant increases the pie. The pie captures social value. The pie is not financial value or economic growth. So you create social value as a tobacco firm when you cease the production of tobacco.

BE VERY WARY OF THE PHRASE 'RESEARCH SHOWS THAT', BECAUSE YOU CAN ALWAYS HAND-PICK A RESEARCH PAPER TO SHOW WHATEVER YOU WANT TO SHOW. BE CAREFUL WITH PUTTING TOO MUCH WEIGHT ON A SINGLE PAPER AND TRY TO UNDERSTAND BOTH SIDES OF ANY ISSUE

The pie thereby becomes a qualitative judgment instead of quantifiable number, right?

Yes, one thing that concerns me with ESG is that it reduces everything to a quantitative calculation when most of the important decisions that you make are not quantifiable. So how do you determine whether a decision has grown the pie? You think about all the positive and negative consequences for society. For tobacco, on the one hand, it does a lot of harm in terms of health, but on the other hand it gives people jobs and so on. Then you use your judgment. So for me I would acknowledge that people are given jobs, but their job involves spreading lung cancer. Thus it's not about jobs per se, but about what people are doing in their job. So I think tobacco companies should be reduced.

We talked mostly about social value, but planetary boundaries get more and more attention recently. How does your book relate to climate and biodiversity concerns?

What I don't like about some of the more recent movements is that they claim we only need to look at climate change or at biodiversity. Yes, both aspects are very important, but as we've seen recently, people do need energy and if we are to shut down all coal fired power stations and fossil fuel generated energy, then we won't have enough energy for the world's current needs. So what is good and what is bad? I think we need to assess all of the effects in the wider society rather than examining one single issue.

Many thanks on all your perspectives on ESG and long-term value creation. As a last question: Do you have recommendations for our CFA charter holders concerning their career and their ongoing education?

I'd like to highlight that ESG is very important to everybody even if you are not in an ESG-specific role, but I'd also say that ESG is nothing special. It should not be put on a pedestal compared to other value drivers.

For investment managers, research is obviously very important as you'd like to see what drives long-term returns. But beware that there is a lot of really bad research out there, produced by both consultancies and academics alike. There are incentives to present one-sided research on for example the relationship between diversity and firm performance, but if you carefully look at the data, relationships are usually much more nuanced.

In addition, be very wary of the phrase 'research shows that' because you can always hand-pick a research paper to show whatever you want to show. Be careful with putting too much weight on a single paper and try to understand both sides of any issue.

Thank you, Alex!